

**DEPARTMENT OF STATE REVENUE**

**LETTER OF FINDINGS NUMBER: 94-0668 IT  
Gross Income Tax — Best Information Available  
Adjusted Gross Income Tax — Subpart F Income  
Tax Administration — Negligence Penalty  
For Tax Periods: 1986 Through 1989**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

**ISSUES**

**I. Gross Income Tax — Best Information Available**

**Authority:** IC 6-8.1-5-1(a) and (b)

Taxpayer protests the sampling technique used by Audit in calculating taxpayer's taxable gross income on the best information available.

**II. Adjusted Gross Income Tax — Subpart F Income**

**Authority:** 45 IAC 3.1-1-29; 45 IAC 3.1-1-60; 45 IAC 3.1-1-61  
*Allied-Signal, Inc., v. Director, Division of Taxation*, 504 U.S. 768 (1992)

Taxpayer protests Audit's characterization of taxpayer's Subpart F dividends as business income.

**III. Tax Administration — Negligence Penalty**

**Authority:** IC 6-8.1-10-2.1  
45 IAC 15-11-2

Taxpayer protests the imposition of a ten-percent (10%) negligence penalty.

**STATEMENT OF FACTS**

Taxpayer, a Delaware corporation created from a 1986 corporate merger, is domiciled in Pennsylvania. During the audit period, taxpayer had seven (7) Indiana locations.

Taxpayer is in the computer and information management business. Taxpayer designs, manufactures, and sells computer systems and software. Additionally, taxpayer leases equipment and provides related services, maintenance contracts, facilities planning, as well as a variety of custom products.

Taxpayer filed Form IT-20 for tax periods 1986 through 1989. On schedules (Schedule F-1) attached to Form IT-20, taxpayer reported amounts of dividend income as "nonbusiness income" - income not subject to apportionment for Indiana adjusted gross income tax purposes. Audit characterized the dividend income as "business income." Audit's reclassification resulted in an increase in taxpayer's Indiana adjusted gross income.

Audit also discovered that taxpayer had failed to segregate its Indiana gross receipts on its Indiana gross income tax returns. Additionally, Audit found that taxpayer's records could not support the amounts that were reported by taxpayer on its Indiana returns. Consequently, the audit was based on the best available information.

## **I. Gross Income Tax — Best Information Available**

### **DISCUSSION**

Taxpayer protests the method used by Audit to determine taxpayer's gross income tax.

Because taxpayer's records could not substantiate the amounts reported on its Indiana corporate income tax returns, Audit used a sampling technique to compute taxpayer's taxable gross receipts. Taxpayer argues that this sampling technique resulted in an overstatement of its Indiana sales, and consequently, its taxable gross income. As an acceptable alternative, taxpayer suggests the use of its sales receipt figures. Taxpayer believes that if Audit had used the sales receipt figures taken from taxpayer's previously audited sales tax returns, a more accurate determination of gross income would have resulted.

Taxpayer contends that its gross income for the years in question should equal its Indiana sales receipts as reported on audited sales tax returns. Taxpayer reasons that since the sales tax receipts were the basis for its quarterly estimated gross income tax, these sales tax receipts should also be an accurate estimation of its annual gross receipts.

The Department's use of the best information available in calculating taxpayer's proposed assessment is authorized under IC 6-8.1-5-1(a), which provides in part:

If the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department.

Under the circumstances, Audit's reliance on the best information available to calculate taxpayer's gross income tax was justified.

According to IC 6-8.1-5-1(b):

The rate of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.

While taxpayer disagrees with the results of the audit, taxpayer has not offered evidence or advanced arguments to refute either Audit's methodology or results. The sampling techniques used by Audit conform to generally accepted accounting principles. Audit believed the results arrived at through the use of these sampling techniques would best reflect taxpayer's taxable gross receipts for the years 1986 through 1989.

### **FINDINGS**

Taxpayer's protest is denied.

## **II. Adjusted Gross Income Tax — Subpart F Income**

### **DISCUSSION**

Taxpayer protests Audit's characterization of taxpayer's Subpart F dividend income as "business income" – income subject to apportionment for Indiana adjusted gross income tax purposes.

Audit characterizes taxpayer's subpart F income as "business" income. Audit arrives at its conclusion by finding that the source of taxpayer's Subpart F dividends was either foreign corporations that used taxpayer's patents and/or processes that were developed in the normal course of the taxpayer's business or foreign corporations that marketed taxpayer's products.

Audit supports its conclusion by citing 45 IAC 3.1-1- 61, which states:

Patent and copyright royalties are nonbusiness income if the patent or copyright with respect to which the royalties were received did not arise out of or was not created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the patent or copyright is not related to or incidental to such trade or business operations.

Additionally, Audit invokes 45 IAC 3.1-1-60 Ex. (5).

The taxpayer receives dividends from the stock of its subsidiary or affiliate that acts as the marketing agency for products manufactured by the taxpayer. The dividends are business income.

Taxpayer, in response, maintains that its subpart F income represents "deemed dividends" – i.e., interest from investments in foreign subsidiaries. Taxpayer reasons that since its principle business does not include investments in subsidiaries, income derived from these investment

activities should not be classified as business income. Rather, consistent with Indiana statutory language, this investment income should be classified as nonbusiness income. And nonbusiness income cannot be apportioned to Indiana.

The foundation upon which taxpayer's argument rests is 45 IAC 3.1-1-29, which defines business income.

Income of any type or class and from any source is business income if it arises from transactions and activities occurring in the regular course of a trade or business. *Accordingly, the critical element in determining whether income is 'business income' or 'non-business income' is the identification of the transactions and activity which are the elements of a particular trade or business.* (Emphasis added.)

Taxpayer directs the Department's attention to *Allied-Signal, Inc., v. Director, Division of Taxation*, 504 U.S. 768 (1992). *Allied Signal* reinforces the unitary business rule that prohibits states from taxing income earned from activities unrelated to activities conducted by the taxpayer in the taxing state. The Court in *Allied Signal* explained that while the unitary business rule is "a recognition of the States' wide authority to devise formulae for an accurate assessment of a corporation's intrastate value or income [it also places] necessary limit[s] on the States' authority to tax value or income that cannot fairly be attributed to the taxpayer's activities with the State." *Id.* at 780.

While *Allied Signal* does provide guidance, absent additional facts, the Department is unable to determine whether taxpayer's situation is analogous to that of the taxpayer in *Allied-Signal*. In taxpayer's letter of protest, and at hearing, taxpayer has failed to develop legal arguments, discuss Indiana authorities, or provide additional supporting information.

Taxpayer also argues that Indiana's treatment of Subpart F income is "facially discriminatory against foreign commerce in violation of the Foreign Commerce Clause of the United States Constitution." Taxpayer directs the Department's attention to *Kraft General Foods, Inc. v. Iowa Department of Revenue*, 505 U.S. 71 (1992). Taxpayer, however, does not develop this argument.

Again, as IC 6-8.1-5-1(b) states in part:

The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.

In this instance, taxpayer has failed to meet its burden.

## **FINDING**

The taxpayer's protest is denied.

### **III. Tax Administration — Negligence Penalty**

## **DISCUSSION**

Taxpayer protests the Department's imposition of the ten-percent (10%) penalty. A negligence penalty may be imposed under IC 6-8.1-10-2.1 and 45 IAC 15-11-2.

45 IAC 15-11-2 provides:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-2.1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

Taxpayer's records could not support the amounts reported on taxpayer's Indiana corporate income tax returns. As a result, the audit had to be completed using the best information available. Audit assessed a negligence penalty because taxpayer was not diligent in the research and preparation of its tax returns.

Taxpayer contends that it did, in fact, make reasonable efforts in calculating and remitting the correct tax due - even though reported amounts were based on the best information available to taxpayer at the time of filing. Taxpayer attributes any underreporting to "exceptional circumstances" - i.e., the corporate merger of 1986. Taxpayer also maintains that the turnover of personnel in the tax department, both before and during the audit, contributed to the reporting discrepancies.

While taxpayer has offered an explanation for these tax discrepancies, taxpayer has not shown reasonable cause under 45 IAC 15-11-2.

## **FINDING**

The Department finds that the negligence penalty is appropriate. Taxpayer's protest is denied.